RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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July 5, 1979 **LETTER 760**

June 21, DJIA 849.10; PTI 1021; A-D Ratio –18.52
June 28, DJIA 841.98; PTI 1035; A-D Ratio –18.36

THE MARKET: On June 29 Dow Jones tossed out Esmark and what was left of Chrysler and substituted Merck and IBM. Thus, two old veterans leave and two more glamorous items (both leaders in their fields) arrive. But wait–Merck hit its record high of just over 100 in 1973 and has not been back since (despite steadily increasing earnings). IBM recorded its high of just over 360 in 1973, and steadily rising earnings have not yet taken IBM to a new high. Yet, I feel the change is a good one, and Dow Jones is to be complimented.

It is relatively easy to substitute stocks in the Averages, but it isn't easy to get a bull market going. The 1976 high for the Dow was 1014.79. The 1977 high was 999.75. The 1978 peak was 907.24. And the peak so far in 1979 is 878.72 recorded on April 10. It could be that IBM and Merck will supply the needed upside juice. I'm skeptical, but time will tell.

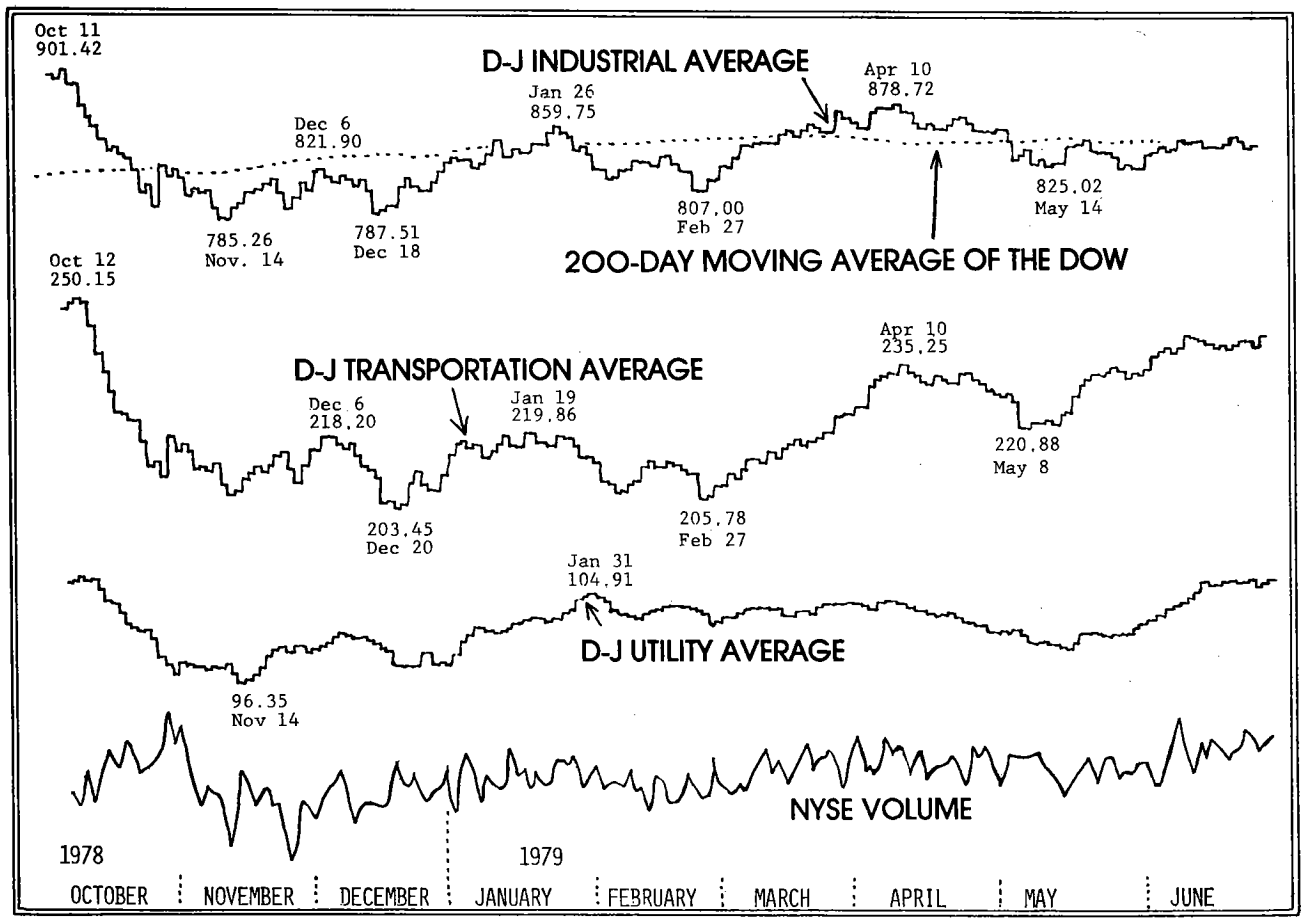
The Transports have been putting on a considerably better show. The 1976 high for Transports was 237.03. The 1977 high was 246.64. The 1978 high was 261.49. And this year's peak has yet to be seen (Transports are at a 1979 high).

Last year (1978) saw the last confirmed highs in the two Averages. The carriers want to go higher now, but the Industrials have been outstanding laggards, and their April 10 peak of 878.72 stands as the target which must be bettered if this market is to have a clear bullish look about it.

Front Page Comment: The dread of economic recession with accompanying massive deficits (from tax shortfalls) rules everything the Fed and the Administration think or do. The US said "no" to Europe's plan for a 5-year freeze on oil imports. The Fed does nothing (so far) in the face of exploding inflation and a renewed slump in the dollar. Europe, in the meantime, has been raising its own interest rates, fighting inflation and getting rid of dollars as fast as it politely can. Britain (with the pound rocketing higher) has raised its minimum lending rate from 12% to 14%. The pressure is increasingly on the Fed to get off its hands. But will it?

Normally, interest rates tend to be 1 to 2% above the prevailing inflation rate. A strong anti-inflation stand would see an even higher interest rate spread than that. With the inflation rate in the US now around 13%, it would be "normal" for money market instruments to bring real returns of 2% or more which means interest rates of 15% or more. But currently bill rates are under 9% and bond rates at a bit higher. Thus, US money markets are anything but tight.

If the dollar is on its way to a renewed collapse, the Fed and Mr. Carter will have to face the combination they are most afraid of–higher interest rates plus recession. It could happen.



Most people do not realize that the Dow has made lower peaks ever since 1976, and I find myself wondering how long this declining series can go on. Common sense (which doesn't always work on Wall Street) would suggest one of the following: (1) The series of declining peaks should soon come to an end, if not this year then perhaps 1980, or (2) a downside washout should finally produce an over-sold market from which the Dow can finally start moving up with conviction.

From the nearer term standpoint, we have two Industrial markers to watch, even while Transport strength continues. The first mark is the June 22 peak of 849.10 on the Dow. If the Dow can better this level, it will be a definite plus. The next level to hurdle would be the 878.72 high for 1979. If the Dow can better 878.72 the picture will take on a decidedly more bullish hue.

The sluggishness of the Industrial Average during 1979 is truly extraordinary. My momentum studies for the Dow are now breaking down, and this implies that upside progress should be even more laborious from here on. Furthermore, on any weakness I would expect the Dow to be a trail-blazer on the downside.

Turning to the chart below, note that here too we have to deal with a glaring divergence. The Primary Trend Index (PTI) is an amalgam of 8 critical indices and averages, and it acts as a broad technical market syndrome. By any reading, the PTI has been a powerhouse during 1979. As this is written, the PTI has pushed to another post-1974 recovery high, and even over the past few weeks when the news was dimmest, the PTI gave ground during the decline in the most grudging way. I will repeat that I do not expect trouble until the PTI turns resolutely down. The acute divergence between the Dow and the PTI goes on. How long this kind of divergence can continue I simply do not know (the persistence of the divergence has already surprised me).

Meanwhile, the A-D ratio, which is a proxy for the entire NYSE, has just pushed to an uninspiring 1979 high. I say uninspiring because as this is written the A-D is still well below its peak of last September, which means that the losses of the "October massacre" have still not been recouped.

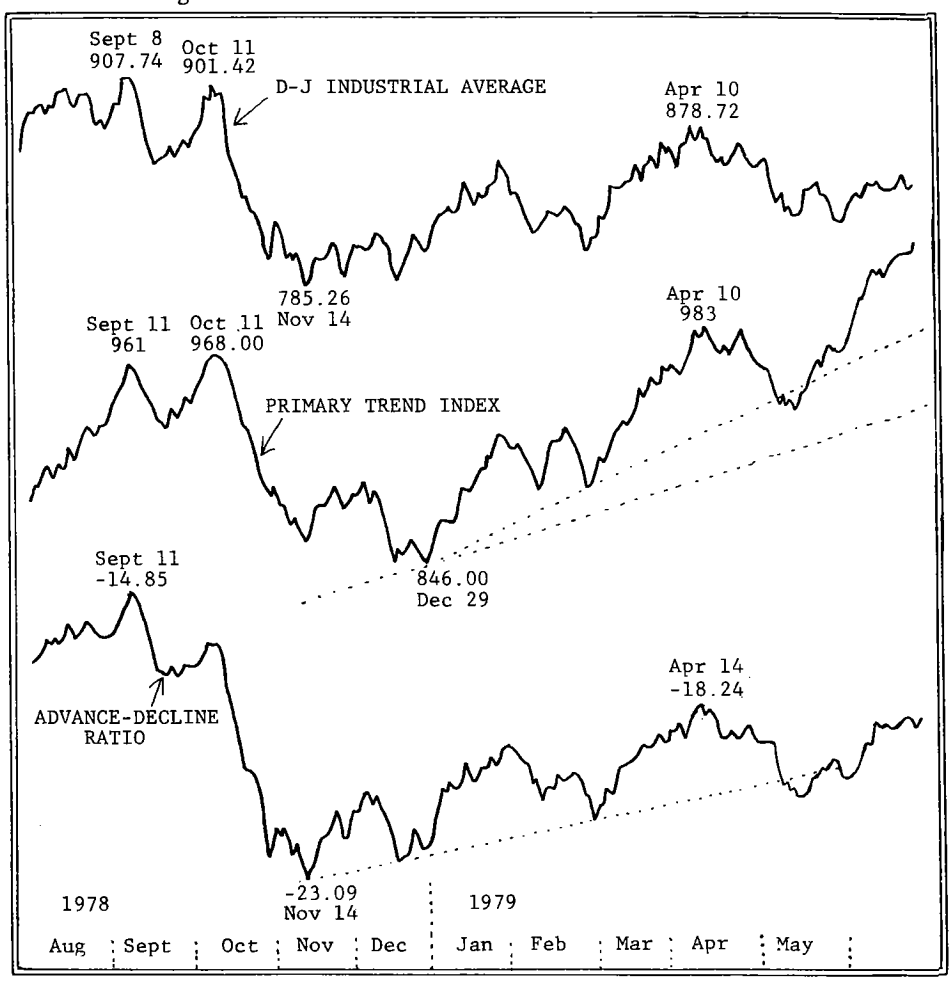
Some of my other indicators show that the market is now in a very over-bought condition, and this implies that there will be no major rise from this area (although there could be more plodding and huffing and puffing on the upside). As I see it, the forces of inflation have been exerting a steady upside pressure on the market while the heaviness of the Dow and the sluggishness of the breadth indices have been exerting a persistent dragging effect to the markets. Result: a strange stalemate with the market remarkably resistant to both good and bad news. It's like a car running with the brakes on.

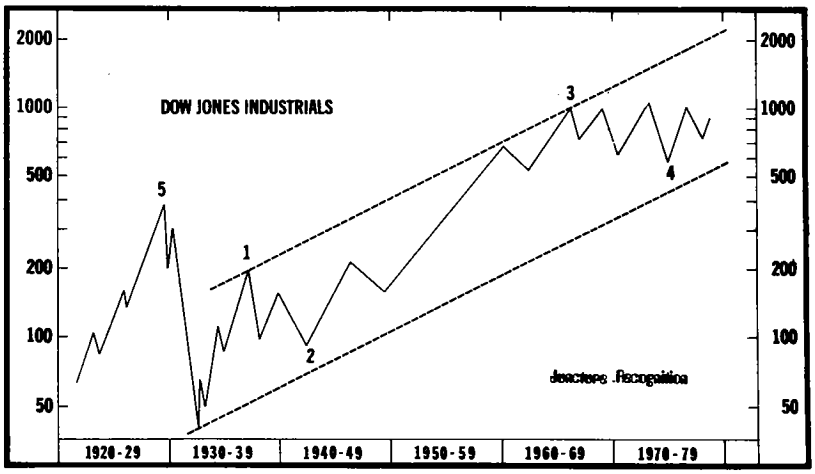
THE BIG PICTURE: The picture in the stock market today is one of acute confusion. Of course, there's nothing wrong with confusion. It is to be expected in this business. Robert Rhea, the great Dow Theorist of the 1930's wrote, " . . . *perhaps 90% of my time is spent in perplexity,*" and Rhea, to my mind, was the greatest of all market interpreters.

I have been pondering the Wall Street situation long and hard, wondering how I should best approach it for my subscribers. For I believe that we are at a juncture in the market that is as IMPORTANT as it is confusing. Perhaps the most helpful approach would be a "best case" and a "worst case" discussion of the current situation.

Let's take the best (most bullish) case first. The most bullish case is the one that is made by many leading students of the Elliott Wave principle (both Bob Prechter and A. J. Frost espouse the picture that I will now describe). The same case is graphically put forth in this chart (page 3) by Bill Bretz (Juncture Recognition, Box 1209, Pompano Beach, FL 33061). The chart shows a massive super-cycle which began at the 1932 low of 41 on the Dow. The first bull wave took the Dow to the 1937 peak of 194. The correction to point 2 returned the Dow to a 1942 low of 92. The third bull wave extended to the 1966 high of 995. And the very complicated corrective wave 4 smashed the Dow down to the 1974 low of 577.

According to this view, we are now moving up in the final bull wave 5, even though the Dow is still only 265 points above its 1974 low. Both Prechter and Frost expect the 5th wave to carry very much higher. Prechter estimates 2860 on the Dow by 1983 (strangely, Value Line espouses this bullish view of the market but from the standpoint of fundamental analysis). What could occur to make this fantastically bullish case come true? First, we know that the Dow is "cheap" by historical standards. I think the second chart on p. 3 (courtesy Schabacker Inv. Mgmt., 13024 Chestnut Oak Dr., Gaithersburg, MD 20760) tells the story. In brief, the Dow is now in the "bargain zone" from the historical standpoint of price/earnings ratios, return on dividends and





from the standpoint that it is currently selling below book value for only the fourth time since the 1930's

What could be the impetus to drive the Dow and the rest of the market into orbit, as projected by Elliott theorists? Inflation immediately comes to mind. After all, housing has careened into the wild blue yonder, collectibles have exploded in price, gold and the other precious metals have made major moves, commodities in general are now pushing higher. So what is left but common stocks? At some point (and possibly soon) the institutions and the public are going to realize that the only values left on the investment landscape are stocks–and then the rush could begin.

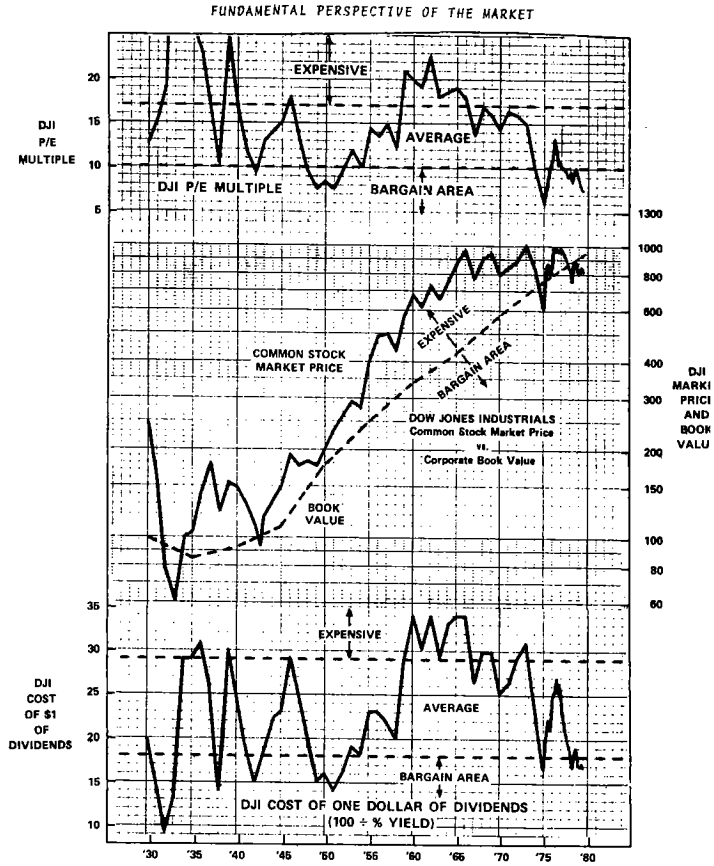
From a contrary standpoint one could also say that for years and years the US has done everything wrong. From Vietnam to inflation, from gaping deficits to pathetic Social Security mismanagement, you name it and the US has made a mess of it. Now people are fed up, and from a contrary viewpoint it is possible (happy thought) that the US is going to start doing things right. I can't think of a more contrary opinion!

That, in brief, is the most bullish argument. And I don't dismiss it. After all, this market has been absorbing wave after wave of the rottenest news seen in years here during 1979–and the market simply has not caved in. My Primary Trend Index has climbed to its highest level since the 1974 bottom, despite the bad news and despite the monumental resistance of the Dow. Shouldn't we conclude that the market is "looking somewhere else" but not at the bad news? Couldn't that "somewhere else" be the fifth and final tremendous bull wave under Elliott? Stranger things have happened on Wall Street.

All right, how about the most bearish case? How can we fit today's market into that scenario? The bears tell us that the recovery from the 1974 lows is running out of time. This Fall will mark the fifth year since the 1974 lows, and the market is overdue for trouble, perhaps horrendous trouble. We appear to have skipped the surest thing in the market this year, and that is the bottoming of the 4 to 4½ year cycle. Study the page 4 chart of the NYSE Stock Index (chart courtesy of Security Research, 208 Newbury St., Boston, Mass 02116). Here we see the 4 to 4½ year cycle in action, hitting its lows in 1949, 1953, 1957, 1962, 1966, 1970 and 1974. But–where is it now? Could inflation have blotted the cycle bottom out this time? Has the 4 year cycle ended? Perhaps, but the fact is that this market has not registered a major over-sold condition since late-1974. And what bothers many market veterans is the old adage, "the longer the market puts off an over-bought or over-sold situation, the more extreme that situation will be–when it finally arrives."

At any rate, the absence of a major over-sold bottom since 1974 is a major deterrent to buying, and the longer this situation goes on, the more fidgety market veterans become.

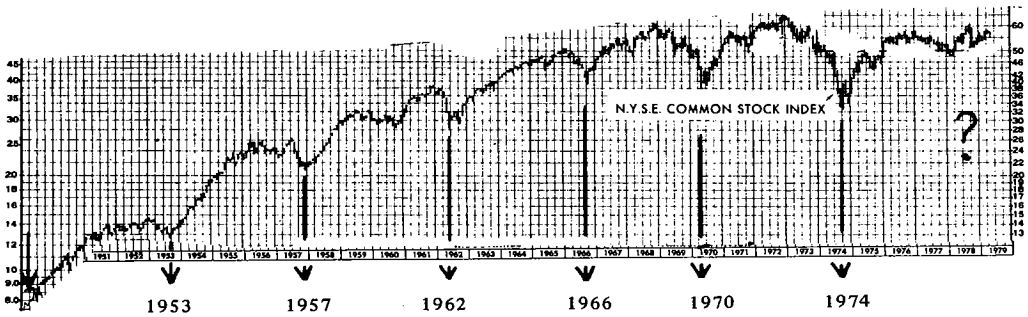
Next, we have the monetary situation, something which I have talked about over and over again. But the fact is that no market in history has ever performed "to bull market standards" in a negative monetary environment such as the present one. The Bank Credit Analyst's monetary thermometer is now extremely bearish, and the odds are that the market will ultimately respond to this pressure. The yield curve in the money market is still negative with one-year bills yielding more than 91-day bills.



But overall, perhaps the worst part of the picture is that the economy is running out of control from the inflation standpoint, and eventually the Fed will have to make its move to bring the forces of inflation under control again.

Finally, we have the bearish thesis that the total debt of the US and its citizens and its corporations is now running wild. What does this mean? It means that the COST of servicing the debt in the US is so high, so unmanageable, that we can never again (under this economic system) have low interest rates. Worse, it means that each low in the interest rate cycle must be higher than the last and each high will be a record peak. Of course, this is the path to bankruptcy, a path that many informed observers believe we are on.

This built-in ride to destruction is being factored into the stocks of America's major corporations, runs the argument, and that is why price/earnings ratios will sink lower and lower with each



new decline in the stock market. For the equities of an inflation ridden system are worth less and less, and finally earnings will be worth literally nothing. At that point, stocks will be selling at bargain prices that will make today's prices look expensive.

"But can't we get off the inflation-debt bandwagon?" ask the dissenters. And the answer they are given is "No, the mess has gone too far. Only a cancelling of the debt or a total reorganization can keep the debt-ridden US system going, if indeed, you can call that keeping the system going."

So there we are. I've tried to paint a picture of the two opposing pictures in broad terms. The question may be asked, "Russell, how do you personally see it? What do you actually think?" And here my only answer is that I think we today are seeing a pause in a system that is literally out of control. I sense that the market is now trying to make its mind up as to the whole situation. I sense that the market itself has not decided whether the bullish argument (the inflation hedge argument) can hold up, and thus the market is not yet ready to take off a la Elliott.

If I had to guess about where the market was going over the rest of 1979, I would guess that the stalemate of negative monetary conditions and a weak Dow and poor breadth action would balance off the pressure of "good values waiting to be bought" and rising inflation. These two opposing forces could give us virtually trendless markets right through the end of the year and even beyond. When I say trendless I mean a trading range market with the Dow locked in to a band of perhaps 790 on the downside to 890 on the upside.

Wall Street and the public hate a trading range more than anything else. A trading range is a bore, it is tedious and frustrating, and worst of all it tends to produce losses–individual stocks run up, then fall away as another group takes over favor.

I haven't forgotten my Fibonacci prediction of an important market juncture in July. And I'll go into this further in the next Letter. In the meantime, I'm mapping out a strategy which I hope will serve subscribers well as we go along. One thing I've learned anew here in 1979: Speculators are very quick to talk about their winnings, their dramatic victories. But you hear very little about the losses, and there are many more of those than there are winnings, many more.

THOUGHTS: After three decades of dealing with myself and other investors, I've had time to make some observations and draw some conclusions. I've learned a lot from people's successes, and probably even more from their failures. Here are a few of my thoughts:

(1) Only a small percentage of people understand what they're trying to do with their investments. People tend to lose sight of the thesis that we are all trying to increase (or at least retain) our purchasing power.

(2) The average person tends to get sidetracked with the fashion or craze of the day. Thus, he will trade (when he's not equipped to trade) or he will speculate (when it makes absolutely no sense) or he will invest in the wrong item at the wrong time.

(3) Very few people are able to stick stubbornly with a system, even a winning system. A corollary: very few people are able to resist following the path of a supposedly "wildly successful" neighbor or friend.

(4) My life will be easier when subscribers understand that a series of five trades with an average loss of 10% each means the loss of better than 50% of your capital. A corollary: you can usually increase your capital just by avoiding losses. Thus, when people ask me what I do for a living, I often say, "I try to keep investors from losing their money."

(5) I list the following as the three greatest hazards in investing and in the accumulation of money: (1) greed, (2) impatience, (3) ignorance of the laws of compounding.

(6) I know some individuals who have amassed fortunes through trading, but I can count these individuals on the fingers of my two hands. Most of the fortunes I have seen or heard about were garnered by those who understood values and the virtue of patience. I know ten people who have accumulated large amounts of money through the magic of compounding for everyone who has built a fortune through trading the markets.

(7) A psychoanalyst once told me, "It's easy to get married, but it is hard to stay married." For investing I'll paraphrase that observation to run, "It's easy to make money but hard to keep it."

(8) Investing means buying something which will provide a return (a yield). In buying a commodity, you are always speculating because there is no return on the item you buy. Thus, it is difficult and almost impossible to judge the value of that commodity. If I buy a stock or a bond and either one yields 8%, I can judge the floor on that stock or bond in case of a decline. If I buy wheat or hogs or copper, I cannot judge the floor on the downside. Thus, it is impossible to "hold" a commodity through a major decline, since there is no way of judging when that commodity is cheap.

(9) Seasoned investors think in terms of ***potential downside risk*** in case of a market reversal. It is relatively easy (on your stomach) to buy a stock that is down following a major market decline as long as the dividend is attractive and in no danger of being cut. Thus great fortunes have been made by investors who understood values, and who had the foresight and guts to step in and buy stocks following panic declines. The best floor under a stock (or bond) following a panic is a high dividend yield which is considered "safe."

(10) The greatest gift (advantage) a young man or woman has in investing is TIME. Instead of going into debt (the usual custom), young people should use their potentially long life span for accumulating securities which provide a good yield. These securities should be allowed to compound. Consider this: $1,000 invested every year at 8% will compound to $45,000 in 20 years! I strongly recommend that every investor purchase a book of

interest tables (Dow Jones Irwin publishes one) and study those tables carefully.

(11) Sadly, debt works compounding in reverse. The worst mistake a young person can make is to assume a large debt as he starts out in life. Servicing that debt will, in all likelihood, prevent the individual from ever accumulating capital.

(12) I have been asked, "Why accumulate capital?" The answer to that must be a personal one. My own answer is that money allows you a certain degree of freedom. It also allows you to avoid a good many of the unpleasant problems of life. Money obviously does not guarantee happiness, but it does guarantee that you can avoid many frustrations. Worrying about paying bills and worrying about "scraping through life" are a tremendous drain on your time, your nerves and your energy. Having capital will allow you the luxury of spending your life more intelligently. The surest way to have money (contrary to what most everyone says) is to start *accumulating early*.

NOTES & QUOTES: The great interest rate debate rages on. On the charts (see Bonds, last Letter) it would appear that an important bottom has been seen in the bonds. But I'm not fully convinced. Nor is the authoritative Bank Credit Analyst, nor is Dr. Henry Kaufman of Salomon Bros. (for whom I have great respect). Nor, it seems, is Albert Wojnilower, managing director of First Boston Corp., a man whose opinions I value highly. In the current *Fortune* magazine, Wojnilower states, "The peaking-out phase of a business cycle may be viewed as a turbulent and usually long transition during which a slowdown due mainly to inadequate capacity is gradually transformed into one due primarilly to insufficient demand. It seems that we are in the throes of transition . . . . I suspect the true peak in long-term corporate Treasury bond yields may still be a long way off, in time as well as in level."

My own thinking is that I would not go more than 25% to 33% into bonds at this time. I would deal in only the most liquid bonds or preferably with an open-end bond fund. Fidelity Municipal Bond Fund (see last Letter) made a new recovery high of 9.60 last week. This fund can still be purchased with a stop-loss below 9.46.

* *

This from a subscriber (C.R.N.) in Los Altos Hills, Calif.). "An order of succession in government was first put into words by Plato. His order was:

1) Government by one man (monarchy or tyranny).
2) Government by a few (aristocracy or oligarchy).
3) Government by the many (democracy).
4) Revolt against the government (anarchy).
5) Back to rule by a single person (dictatorship or tyranny).

"Our country has already been ruled by a king. Next by an aristocracy that drew up the Constitution. One cannot but think that Rousseau's comments (preceding the French Revolution) apply to our present government and that we are rapidly approaching the end of democracy in the US. I can only hope that I am no longer around to witness Plato's stage 4."

* *

In the June 28 Wall Street Journal, Peter Drucker (editorial page) talks about a new international or "transnational currency" which may be in the process of forming. This would leave many nations (the US in particular) free to print an internal currency (for citizens only). To my mind, the minute the US resorts to an internal currency, its leadership in the world ends, and the US becomes just another oversized nation struggling to hold its head above water.

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Here's a rather fascinating comment about Ugandan finances. I hope this doesn't give our Treasury (which, I believe, reads these Letters) any ideas!

The Washington Post

KAMPALA, Uganda—An agent for a British money-printing firm recently related how several years ago he personally negotiated a contract with Ugandan dictator Idi Amin to print 2 million shillings worth of 100 shilling notes. At the close of their talks, he gingerly asked how he was to be paid.

"Print 3 million and take 1 million for yourself," Amin angrily retorted.

* *

Everyone should subscribe to Smithsonian magazine (900 Jefferson Rd., Wash. DC 20560, $12 annually). I am a magazine freak, and I must subscribe to at least 40 magazines. None are more informative and pleasurable than Smithsonian. In the current (July) issue is an article about the fabulous Edward Weston, perhaps the greatest walker of all time. Weston walked the length and breadth of the US for both money and prizes. He walked from Portland to Chicago (1326 miles) in 30 days (never on Sunday) for a prize of $10,000.

Weston, ironically, was hit by a taxi at age 88 (he hated autos) and finally died at age 90 in 1929. Weston seemed to understand what doctors today are finally understanding, that walking is probably the greatest longevity "medicine" in the world. My only regret in this business is that I don't have more time for walking. I jog in the mornings, but I would (if I had time) walk 4-5 hours per day. I would love to walk from San Diego to New York. I can't resist inserting this quote from the Smithsonian article.

> The *Saturday Evening Post* once quoted him giving advice that echoes well today: ". . . Most of the men I have met between the ages of forty and seventy could make themselves feel years younger by taking to the open road and—barring hearts that are too far gone to be salvaged—could be assured of longer and happier lives. More than that, all of them would be astonished at the vigor that comes of long, regular, easy-gaited walking, and the positive eagerness it will develop for more distance . . . as for the younger men, sometimes in watching the mad pace of modern life I wonder if they are not more in need of hikes than their grandfathers. Walking would teach them the quality that youngsters find so hard to learn—patience. It would give them proof that the race is not to the swift."

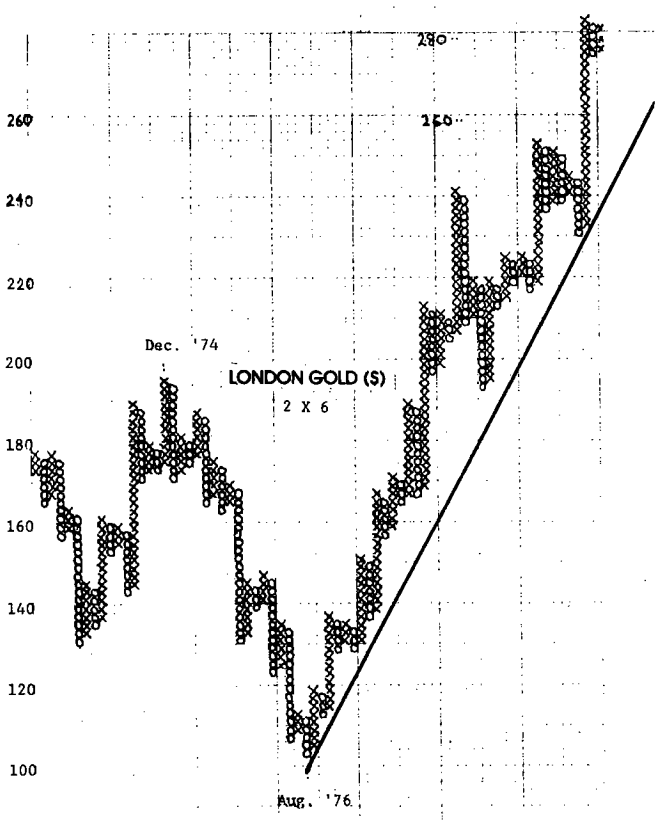
LATE NOTES: On the first Friday of 1979 (January 5) the NYSE Index was 55.41, the S&P 500 Average was 99.29, the Dow was 830.73. At the end of the six month period (June 29) the NYSE Index was 58.36, the S&P 500 102.91 and the Dow was 841.98. Average gain for the four indices was 3.6%. Over the same period the A-D ratio on the NYSE has gained 2.09 points. All in all that's a lot of work for very little gain. What is the market telling us?

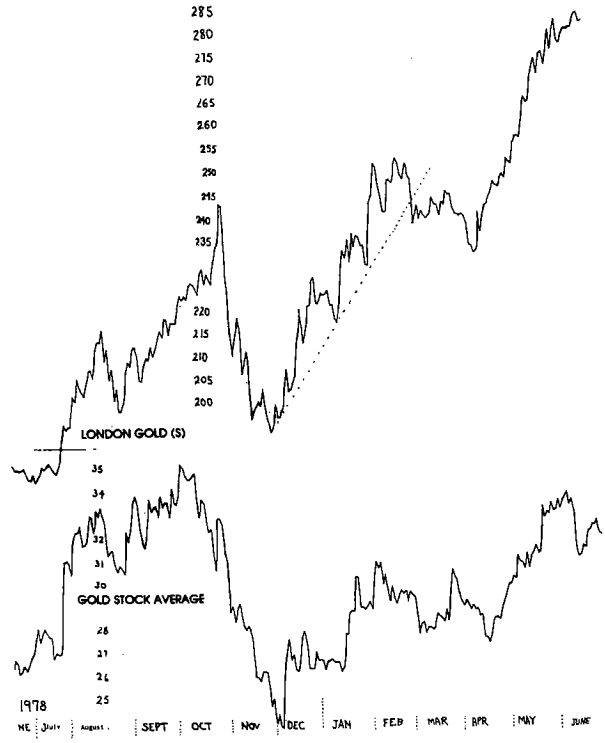
Bulls can say that the market absorbed an endless stream of bad news without cracking. Bears can state that no amount of inflation, spending and pump priming can move this market higher. My momentum studies for the Dow (after having held above 100 all year) are now breaking down, with the 13-week rate of change being 97.6 this week. This should put the Dow to an interesting test. Ordinarily, I would expect the Dow to start moving down, in line with negative momentum. But if the Dow can hold here while the effects of negative momentum slowly work off, it will be impressive. In fact, a reversal (to the upside) in the one-year decline in Dow momentum may present us with a buy signal, and one worth heeding.

GOLD: Arguing with a trendline in the markets is tantamount to standing on the railroad track arguing with the oncoming 20th Century Limited. My 2 X 6 point and figure chart of London gold (1st and 2nd fixes) seems to say it all. The only tough part of trendline analysis, and this can be very difficult, is picking the proper, the authentic trendline. I think I have the authentic trendline on this chart.

According to this picture, it would take a price of 235 to crack gold wide open, and reverse the main trend from bull to bear. That isn't happening just yet. In fact, a sudden flurry of buying near the close (Friday, June 19) astounded traders by sending March, 1980 gold up the limit (limit moves in gold futures are $10). Toronto gold (spot) was quoted at 283 bid. Thus, the jiggling and shaking of the past few weeks has still not produced weakness in gold. Nor have the predictions of $300 gold (sophisticated" traders like to sell BEFORE a widely-touted price objective is reached).

My chart of daily gold and the gold stock average (GSA) continues to picture divergence, with Campbell Red Lake and ASA stubbornly refusing to move back to their October highs. So far, this has not bred trouble, and there is always the chance that GSA will confirm. Note that in April when GSA broke





the March low, that action set off a reaction. Thus, it may take a breaking of the June low in GSA to tumble gold again.

My 4-week moving average of gold is 279.97. The 13-week MA is 257.37. The 50-week MA is 230.45. Gold dropped down just below the 4-week MA last week, then closed higher late Friday. So far, impressive action.

SEMINAR: Ken Gerbino and the American Economic Council will be holding a gala seminar August 10-12 at the Century Plaza in Beverly Hills. Speakers will be Jim Dines, Bob Bleiberg, Julian Snyder, Mark Skousen, Howard Ruff, Jerome Smith, and many others including yours truly. I'm going to cut way down on my speaking, mainly because it takes a lot out of me including usually three or four days of traveling to and from. But this is sure to be a most interesting seminar, and for full information call (213) 550-6394 or write American Economic Council, 9301 Wilshire Blvd., Suite 304A, Beverly Hills, CA 90210.

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NEXT MAILING: July 18th

A MESSAGE FOR 1979: Guardian Mutual Fund (no-load) is an excellent growth-income fund run by Neuberger Berman, top advisers. If you had put $10,000 in Guardian on June 1, 1950 (first day of operation), then re-investing all dividends you would now have $198,000 which figures at a compound growth rate of 11%. You can get almost this same kind of growth rate with many bonds and bond funds today! Which is why high-yielding bonds (and prevailing high interest rates) provide such vicious competition for stocks today! But as I've said so many times before, bonds are a bore and watching your money compound is a drag. Ponder this paragraph carefully, please!